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INFORMATION MEMORANDUM

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TO: The Secretary

FROM: EB - Eugene J. McAllister EM
ARA - Elliott Abrams

SUBJECT: Special Measures on Mexican Debt

In order to solidify his political base and build support for further economic reforms needed to restore growth, the new Mexican President, Carlos Salinas de Gortari, must push early this year for a significant reduction in Mexico's debt service burden. Given the importance of Salinas' reform efforts to vital U.S. interests, we should be prepared to consider special bilateral measures to assist Mexico in surmounting its external debt problems.

The attached joint EB/ARA staff paper presents an innovative proposal under which Mexico would receive voluntary debt reduction from its commercial bank creditors in exchange for sweeping structural reforms. The proposal has three main features:

-- Banks would exchange their existing claims on Mexico at face value for a new issue of twenty year bonds.

-- During each year that Mexico was in compliance with a medium-term structural adjustment program, it would receive debt and liquidity relief in the form of interest waivers and capitalization.

-- To make the program more attractive for banks, a jointly funded U.S.-Mexican facility would extend a limited interest guarantee.

While we would prefer a plan which did not involve official guarantees, in practice some form of partial credit enhancement may be needed for a voluntary arrangement to succeed. This proposal has been carefully designed to minimize the potential U.S. financial exposure, and the risks involved seem acceptable relative to the U.S. interests at stake in Mexico.

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The attached paper suggests one possible approach to easing Mexico's debt service burden. Existing claims on Mexico would be (voluntarily) converted at face value into a new series of bonds. Under the terms of Mexico's contract with the bondholders, it would earn debt and liquidity relief, in the form of interest waivers and interest capitalization, if it complied with a five-year economic restructuring agreement. To make the debt-bond exchange more attractive and to signal our support for economic reform in Mexico, a joint U.S.-Mexican insurance facility would provide a partial interest guarantee on the new bonds.

The formal conditionality in the program should come from multilateral institutions -- above all the World Bank, since Mexico's greatest need is for long-term structural reform. We should not attempt to establish a formal bilateral linkage between debt relief and Mexican trade and investment concessions. In view of Salinas' apparent commitment to reform and his positive statements on foreign investment, we may achieve better results through a more subtle, indirect approach.

If Mexico converted $30 billion of existing debt and fulfilled its performance requirements, it could reduce the present value of its future debt servicing requirements by almost $5.5 billion. More importantly, Mexico could lower its payments over the next decade, the most critical period, by over 40 percent. In order to fund its share of the insurance facility, the U.S. would have to assume a financial risk equivalent to extending Mexico an 8-year, $2 billion loan with a 5-year grace period.

A positive feature of this debt-bond proposal is that it frontloads the relief to Mexico during the first decade when it is most needed. Presumably, Mexico's debt servicing capacity would increase substantially, permitting it to handle the higher payments it would have to make in years 11 to 20. There is, of course, always the risk that Mexico might not be more creditworthy in 10 years, and that a future populist government might object to the increase in Mexico's nominal debt stock as a result of the debt restructuring agreement. But the chances of such a negative outcome are greatly reduced by the fact that any debt relief granted would be so closely linked to policy reforms.

Assuming that a Mexican debt-bond swap proved successful, other Latin debtors could be expected to request similar arrangements. These demands would have to be dealt with on a case-by-case basis. The terms of any further arrangements would have to vary depending on the outcomes of negotiations between debtor countries and their creditors, and any partial interest guarantees would have to come from a broader range of G-7 countries.

Model Debt Restructuring Arrangement for Mexico

Main Elements of the Restructuring

o Under a voluntary restructuring agreement, banks would exchange their existing claims on Mexico at face value for new 20-year bonds.

-- The bonds would bear the same interest coupon as Mexico's existing debt (LIBOR plus 7/8%), and would be retired through a single principal payment in year 20.

-- To give the banks and Mexico greater flexibility, the principal and interest payments on the bonds would be separately tradable.

o During each year that Mexico was in compliance with a medium-term (5 year) Fund/Bank program, it would be eligible for debt and liquidity relief in the form of interest waivers and interest capitalization. As a bonus, Mexico would receive the same benefits in years 6-10, if it successfully completed the adjustment program.

-- In the example below, we shall assume that one-third of Mexico's interest payments would be waived and that one-third would be capitalized in the form of new money bonds.

o A special insurance facility, funded jointly by the United States and Mexico, would guarantee the remaining one-third of the interest that Mexico would be expected to pay. For each $1 billion converted, the present value of this guarantee would be about $126 million.

o Mexico would also establish a special collateral account with the Federal Reserve or the BIS, in order to cover part of the interest and principal payments in years 11-20. If Mexico met its contractual obligations in full, the funds in the collateral account would be applied against Mexico's principal payment.

Costs and Benefits to Participants

o Tables 1 and 2 show how the Mexican program might work in practice, given some interest rate and secondary market price assumptions.

o In exchange for policy reforms, Mexico would receive significant debt relief:

-- Mexico would reduce the present value of its debt servicing obligations on the restructured claims by 45 percent in the first 10 years and almost 18 percent over the entire course of the program.

-- Mexico could obtain significant additional debt relief by repurchasing the principal component of the bonds in the secondary market.

o <u>Commercial banks</u> would, in effect, accept less than face value for their existing loans, but they would obtain several benefits:

-- Assuming a modest improvement in Mexico's creditworthiness and taking into account the reduced risk on the guaranteed interest payments, the new bonds would have an expected present value of almost 60 cents per dollar (versus a current secondary market price of 45 cents).

-- The new bonds would be more readily tradable, encouraging the development of a broader secondary market and creating new opportunities for banks to reduce their Mexican exposure.

-- The insurance facility guarantee would strengthen the case for applying an accounting standard similar to FASB-15 to the bonds, so that banks could carry them at face value and realize their losses over many years in the form of reduced interest income.

o While the <u>United States</u> would have to accept some financial risks, they would be relatively modest, as explained in the following section, relative to the magnitude of the U.S. interests at stake.

-- A purely private debt reduction agreement might be feasible, but some official U.S. involvement would increase the chances that debt reduction could occur in an atmosphere of cooperation rather than confrontation.

-- U.S. involvement would also send a strong signal that we recognize Mexico's recent sacrifices and support further steps toward structural economic reform.

<u>Funding an Interest Guarantee Facility</u>

o Assuming that Mexico converted $30 billion in old debt into bonds, an insurance facility would be required to cover $935 million in annual interest payments for five years on a rolling basis. The guarantee would lapse after the tenth year.

o The facility's maximum risk exposure would be about $3.8 billion, assuming Mexico never paid any interest. Its exposure would fall off sharply beginning in the sixth year.

o A number of mechanisms could be designed to fund such an insurance facility, based on varying combinations of contributions from Mexico, the United States, other creditor governments, and international financial institutions.

o In this example, we will consider a purely bilateral U.S.-Mexican facility (see Chart 1):

-- Mexico would deposit $1.8 billion in reserves with the new facility. These would remain with the facility, but Mexico would continue to receive any interest earned.

-- The United States would assume the residual risk, and would make annual contributions of $300 million over the first five years.

-- Toward the end of the fifth year, the facility would be fully funded, and after year 5 it could begin distributing a share of its capital back to its shareholders.

-- The United States would receive its capital back first, and by year 8 it would have no remaining exposure. In terms of overall risk, the U.S. participation would be roughly equivalent to extending an 8-year, $2 billion loan to Mexico with a 5-year grace period.

o In order for the plan to be effective, non-U.S. banks would have to be eligible. While extending partial guarantees to bonds hekd by foreign banks might be politically controversial, these guarantees would not amount to a "bailout" since all participating banks -- foreign and domestic -- would be making significant concessions in exchange.

<u>Dealing with the "Free Rider" Problem</u>

o The Achilles heel of all voluntary debt reduction proposals is that non-participating banks would share in any future improvements in the debtor country's creditworthiness.

o The best means of dealing with this problem is to create a structure of incentives that strongly discourages "free-riding" by non-participants.

-- Regulatory and accounting rules could be used to encourage participation in a debt-bond swap agreed to by Mexico and a majority of its creditors.

-- The United States, other creditor countries, and multilateral financial institutions could also make clear that they would not intervene, directly or indirectly, to enforce the claims of non-participating banks on Mexico.

Table 1

Mexican Debt Restructuring (with 5 year rolling guarantee)

A. Interest Rate and Secondary Market Price Assumptions

1) LIBOR	8.50%
2) Interest on old debt	9.38%
3) Risk-free rate	7.50%
4) Secondary market price for old debt	0.45 per dollar

B. Present Value Calculations (per US$ 1,000 million in debt/bonds)

Mexico (using LIBOR as discount rate):

1) PV of Scheduled Payments on Existing Debt:	1,083
2) PV of Scheduled Payments on New Bonds:	889
3) Percent Reduction in PV due to restructuring:	17.9%
4) Percent Reduction in PV of Payments in Years 1-10:	44.9%

Banks

1) Expected Present Value of Payments on Existing Debt (Secondary market price)	450
2) Expected Present Value of Payments on New Bonds: (discounting guaranteed interest payments at risk-free rate and other payments at LIBOR+3 %.)	593
3) Gain to banks from restructuring:	143

Interest Insurance Facility

1) Present Value of Interest Guarantees : (discounting at risk-free rate)	126

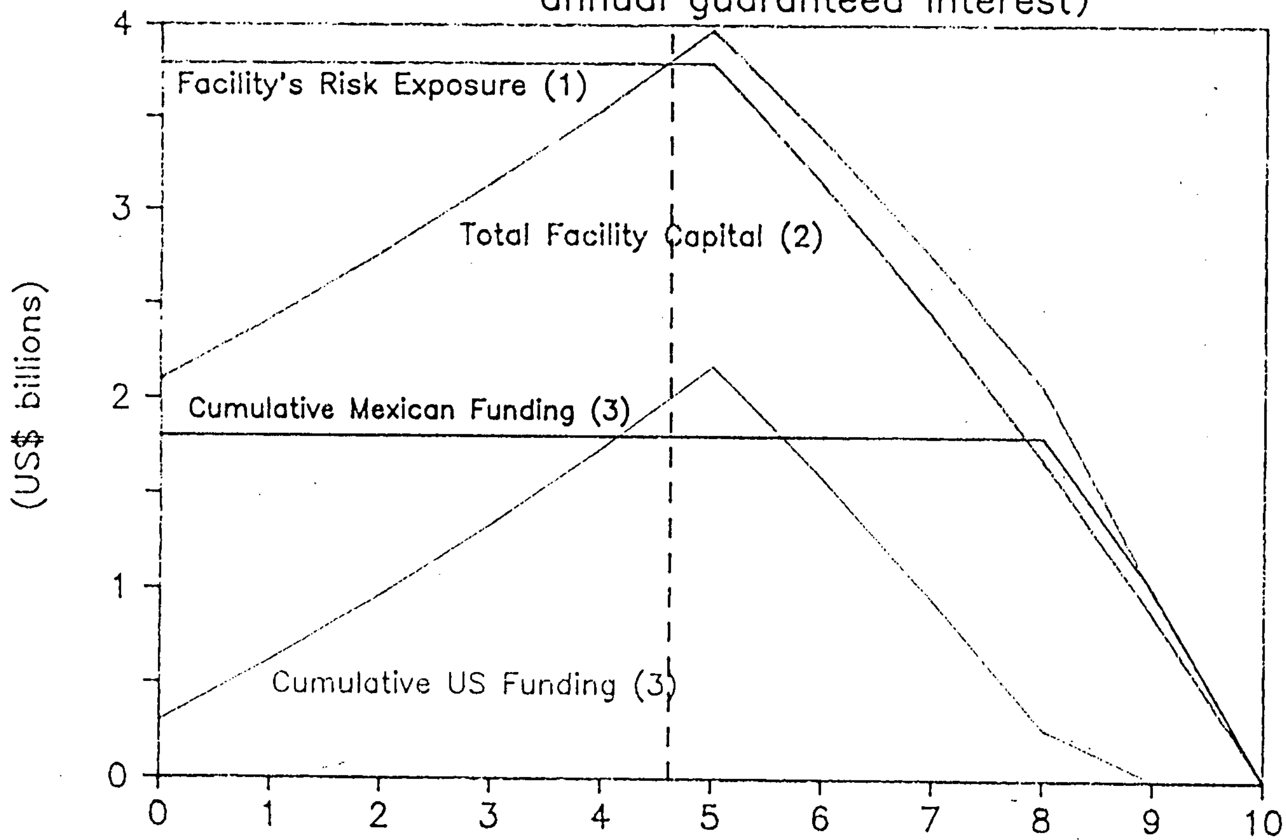
Table 2

Financial Flows under Mexican Restructuring Arrangement

(For $1,000 million in debt/bonds)

Year	Old Payments Schedule	New Payments Schedule	Capital-ized Interest	Guarantee Interest	Debt Stock	Col-lateral Fund	Additions to Col. Fund
1	94	31	31	31	1,000	0	0
2	94	34	31	31	1,031	0	0
3	94	37	31	31	1,063	0	0
4	94	39	31	31	1,094	0	0
5	94	42	31	31	1,125	0	0
6	94	45	31	31	1,156	20	20
7	94	47	31	31	1,188	42	20
8	94	50	31	31	1,219	75	30
9	94	53	31	31	1,250	110	30
10	94	55	31	31	1,281	148	30
11	94	118	0	0	1,281	160	0
12	94	118	0	0	1,281	172	0
13	94	118	0	0	1,281	184	0
14	94	118	0	0	1,281	198	0
15	94	118	0	0	1,281	213	0
16	94	118	0	0	1,281	229	0
17	94	118	0	0	1,281	246	0
18	94	118	0	0	1,281	265	0
19	94	118	0	0	1,281	285	0
20	1,094	975	0	0	1,281	306	0

FUNDING AN INTEREST INSURANCE FACILITY FOR MEXICO
(For $30 billion in debt/bonds; $935 million in annual guaranteed interest)



NOTES:

(1) Present value of remaining risk to facility, discounted at 7.5%.

(2) Total contributions from U.S. and Mexico plus accumulated interest minus capital distributions.

(3) Cumulative contributions plus accumulated interest minus capital distributions.

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